

UKRAINE

The Department of State submitted this report to the Senate Committees on Foreign Relations and on Finance and to the House Committees on Foreign Affairs and on Ways and Means, on January 31, 1999.

Key Economic Indicators
(Billions of U.S. Dollars unless otherwise indicated)

	1996	1997	1998	1/
<i>Income, Production and Employment:</i>				
Nominal GDP	43.10	44.00	40.76	
Real GDP Growth (pct) 2/	-10.0	-3.2	0	
GDP by Sector:				
Agriculture	14.50	5.21	4.48	
Manufacturing	N/A	14.46	11.80	
Services	19.8	20.1	16.7	
Government	N/A	N/A	N/A	
Per Capita GDP (US\$)	854	863	854	
Labor Force (millions)	23.2	22.6	N/A	
Unemployment Rate (pct)	1.6	3.1	3.2	
<i>Money and Prices (annual percentage growth):</i>				
Money Supply Growth (M2)	38.0	39.3	33.2	
Consumer Price Inflation	40.0	10.3	29.0	
Exchange Rate (Hryvnia/US\$ annual average)	1.8	1.9	2.7	
Official	1.89	1.85	2.50	
<i>Balance of Payments and Trade:</i>				
Total Exports, FOB 3/	20.2	15.4	N/A	
Exports to U.S. (US\$ millions) 4/	507	414	N/A	
Total Imports, CIF 3/	21.2	19.6	N/A	
Imports from U.S. (US\$ millions) 4/	394	404	N/A	
Trade Balance 3/	-1.0	-4.2	N/A	
Balance with U.S. (US\$ millions) 4/	113	10	N/A	
External Public Debt/GDP (pct)	19.8	23.8	29.0	
Fiscal Deficit/GDP (pct)	6.0	5.6	2.5	
Current Account Deficit/GDP (pct)	-2.7	-2.6	-2.8	
Debt Service Payments/GDP (pct)	3.5	3.3	N/A	

1998 Country Reports On Economic Policy and Trade Practices: Ukraine

Gold and Foreign Exchange Reserves	2.0	2.4	1.2
Aid from U.S. (US\$ millions) 5/	545.80	369.07	N/A
Aid from All Other Sources	N/A	N/A	N/A

1/ 1998 figures are all estimates based on available monthly data through August 1998, or are 1999 forecast. Source: Government of Ukraine.

2/ Percentage changes calculated in local currency.

3/ Merchandise trade.

4/ Source: U.S. Department of Commerce and U.S. Census Bureau; exports FAS, imports customs basis.

5/ Figures are actual FY expenditures. Cumulative budgeted assistance (credits and grants) for FY 92-97 totals approximately \$2.46 billion.

1. General Policy Framework

Since achieving independence in August 1991, Ukraine has followed a course of democratic development and gradual economic reform. After a period of hyperinflation, it curbed inflation and successfully introduced a new currency, the "hryvnia," in 1995. A tremendous amount of work still lies ahead in the area of economic development and the creation of an economic environment conducive to foreign investment and governed by market forces. Ukraine's economic inheritance from the Soviet Union of a large defense sector and energy-intensive heavy industry has made the transition to a market economy particularly difficult. Ukraine's principal resources and economic strengths include rich agricultural land, significant coal and more modest gas and oil reserves, a strong scientific establishment, and an educated, skilled workforce. Ukraine is an important emerging market at the crossroads of Eastern Europe, Russia, Central Asia, and the Middle East, and holds great potential for becoming an important new market for U.S. trade and investment. A significant number of both large multinationals and smaller foreign investors are present, although private investment (including U.S. investment) is greatly hampered by overregulation, lack of transparency, high business taxes, and inconsistent application of local law.

Ukraine still has much progress to make in the areas of large scale privatization, tax reform, and contract enforcement. Until recently, the government has had great success in efforts to achieve macroeconomic stability. Inflation, for example, was reduced from a rate of approximately 10,000 percent in 1993 to 10 percent in 1997. Inflation for the first eight months of 1998 was just 5.4 percent. The 1998 world financial instability began to affect Ukraine severely in August, however, after the financial crisis in Russia. This, coupled with indigenous weakness in the Ukrainian economy resulting from the general failure to implement economic reforms aggressively, led to a drop in the hryvnia and jump in some prices, resulting in projected annual inflation for 1998 of at least 15 to 18 percent.

The exchange rate relative to the U.S. Dollar had remained steady within a narrow band in 1996 and 1997, but between August 1 and September 30, 1998, the hryvnia depreciated approximately 40 percent against the dollar before stabilizing. On September 4, the IMF approved an Extended Fund Facility (EFF) for Ukraine worth approximately \$2.2 billion. Under the terms of the EFF, Ukraine must accelerate economic reform and significantly reduce its budget deficit (see Section 4).

Ukraine's budget deficit has largely been the result of excessive spending on social programs and subsidies to both noncompetitive industries and private consumers, coupled with inadequate revenue collection. Financing was achieved through a combination of issuance of T-Bills to domestic and foreign borrowers, borrowing from the National Bank of Ukraine (NBU), assistance from international financial institutions (IFIs), and accumulation of wage and pension

arrears. With the onset of the Russian financial crisis in August, however, the market for government debt has largely dried up, and the government has had to rely increasingly upon credits from IFIs, especially the IMF and World Bank. Ukraine has followed a relatively strict monetary policy for the past several years as part of its effort to control inflation and maintain the value of the hryvnia. In the fall of 1998, it began efforts to reduce liquidity through raising bank reserve requirements and increased control of foreign exchange operations.

2. Exchange Rate Policy

In September 1998, the NBU established a new official currency exchange band range of 2.5 to 3.5 hryvnia per dollar, with the maximum permissible difference between the official and legal street rate limited to five percent. All businesses in Ukraine, foreign or domestic, were barred from making advance payment on import contracts, and commercial banks were forbidden to give residents credits in foreign currency. In early September, the NBU imposed a mandatory sale of 75 percent of enterprises' hard currency earnings, though this figure was reduced within two weeks to 50 percent. At the same time, the ability of private banks to purchase foreign currency was significantly restricted; the NBU closed the interbank market for foreign exchange, forcing all FOREX transactions onto the official market, where it exercised stringent oversight.

Such restrictions, particularly the prohibition against advance payment for imports, have produced significant hardships for U.S. firms doing business with Ukraine. U.S. exporters are reluctant to ship goods without prior payment, while U.S. businesses operating in Ukraine (many of which are highly dependent on imports) have had difficulties in obtaining materials necessary for their operations. The NBU has stated its intention to relax these restrictions when circumstances permit.

3. Structural Policies

There are no pricing requirements for consumer goods in Ukraine. Stiff import tariffs and VAT taxes, along with the small number of suppliers of Western products in Ukraine, tend to keep prices of imported goods high. At the beginning of the Russian financial crisis, the Ukrainian Government imposed price controls on some fuel products.

Ukraine's burdensome and nontransparent tax structure remains a major hindrance to foreign investment and business development. Personal income and social security taxes remain very high. Combined payroll taxes were reduced by Presidential Decree from 48.5 percent to 37.5 percent effective January 1, 1999. Tax filing and collection procedures do not correspond to practices in Western countries. Import duties and excise taxes are often changed with little advance notice, giving foreign investors little time to adjust to new requirements.

The regulatory environment is chaotic and Ukraine's product certification system is one of the most serious obstacles to trade, investment, and ongoing business. Procedures for obtaining various licenses are complex and unpredictable, significantly raising the cost of doing business in Ukraine, and encouraging corruption and the development of the shadow economy.

4. Debt Management Policies

Ukraine's foreign debt stood at nearly \$11 billion in late 1998. The largest amount (approximately \$4 billion) is owed to Russia and Turkmenistan, primarily for past trade credits for deliveries of gas, which have been rescheduled into long-term state credits. Ukraine owes about \$4.5 billion to international financial institutions and bilateral export credit agencies. Debt service as a percent of GDP was a little over three percent in 1997. This figure for 1998 is not available but is expected to be higher due to significant payments on T-Bills.

On September 4, 1998, the IMF approved a three year, \$2.2 billion Extended Fund Facility (EFF) intended to overcome balance of payments difficulties stemming from macroeconomic imbalances and structural problems. Monthly disbursements under the EFF are conditioned on Ukraine pursuing more aggressive economic reform, and maintaining foreign reserve levels and a low budget deficit. In September, the World Bank approved credits worth \$900 million for specific projects in agriculture, the coal industry, financial reform, and enterprise development, with disbursements tied to sectoral reform and compliance with the requirements of the EFF.

Also in September, the government rescheduled several hundred million dollars worth of debt due foreign holders of T-Bills. T-Bill holders who had also purchased currency hedges were repaid 20 percent of the amount due up front, with the remainder payable in two year, dollar-denominated Eurobonds. T-Bill holders without currency hedges received 100 percent of the value in two year, dollar-denominated Eurobonds. Those T-Bill holders who refused this arrangement were paid in hryvnia the full amount due. In October, the government rescheduled a \$110 million debt arranged by Chase Manhattan, paying 25 percent in dollars immediately and the remainder in two year Eurobonds.

5. Aid

Ukraine is one of the leading recipients of U.S. assistance. The FY98 Foreign Assistance Act set aside \$225 million for Ukraine, focused on economic reform and privatization, business development, energy and environment (including nuclear safety/Chernobyl), democracy and local government, legal reform, and health and social development. In addition, around \$100 million in other U.S. funding went for exchange programs, Peace Corps, transport of humanitarian supplies, and the Nunn-Lugar Cooperative Threat Reduction Program.

U.S. assistance also reaches Ukraine indirectly through international financial institutions. As stated above, in September 1998, the International Monetary Fund approved a three year, \$2.2 billion Extended Fund Facility designed to promote fiscal reform, financial stabilization, and the accelerated development of a market economy. Major World Bank loans promote agricultural reform, privatization, modernization of the financial sector, and reform in the energy sector. The European Bank for Reconstruction and Development is expanding its role in financing small business development (in conjunction with USAID), and is considering a major role in the nuclear sector, including in improvement of safety at Chernobyl and the possible completion of new nuclear reactors.

6. Significant Barriers to U.S. Exports

The daunting menu of a VAT (20 percent), import duties (ranging from 5 to 200 percent) and excise taxes (10 to 300 percent) present a major obstacle to trade with Ukraine. A limited number of goods, including raw materials, component parts, equipment, machinery, and energy supplies imported by commercial enterprises for "production purposes and their own needs" are exempted from VAT. Many agricultural enterprises are also exempt from the VAT.

Import duties differ and largely depend upon whether a similar item to that being imported is produced in Ukraine; if so, the rate may be higher. Goods subject to excise taxes include alcohol, tobacco, cars, tires, jewelry, and other luxury items. Excise duty rates are expressed as a percentage of the declared customs value, plus customs duties and customs fees paid for importing products. The customs value, however, is fixed at a minimum amount for a number of items, such as used cars.

The significant progress made in the last few years on economic stabilization and the reduction in inflation have improved conditions for U.S. companies in Ukraine. However, foreign firms need to develop cautious and long term strategies which take full account of the problematic commercial environment. The underdeveloped banking system, poor communications networks, difficult tax and regulatory climate, increasing occurrences of crime and corruption, limited opportunities to participate in privatization, and lack of a well-functioning legal system impede U.S. exports to and investment in Ukraine.

Ukraine's domestic production standards and certification requirements apply equally to domestically produced and imported products. Product testing and certification generally relate to technical, safety and environmental standards as well as efficacy standards with regard to pharmaceutical and veterinary products. Such testing often requires official inspection of the company's production facility at the company's expense. At a minimum, imports to Ukraine are required to meet the certification standards of their country of origin. In cases where Ukrainian standards are not established, country of origin standards may prevail.

U.S. exports to Ukraine receive preferential custom rates if the following three criteria are met: (1) the company is registered in the United States; (2) the goods have a certificate to prove U.S. origin; and (3) the goods are imported directly from the United States. There are no special registration or other requirements, according to the State Customs Committee. Duties on goods imported for resale are subject to varying ad valorem rates. Imported goods are not considered legal imports until they have been processed through the port of entry and cleared by Ukrainian customs officials. Import licenses are required for very few goods, primarily medicines, pesticides, and some industrial chemical products.

7. Export Subsidies Policies

As part of its effort to cut the budget deficit, the government has significantly reduced the amount of subsidies it provides to state owned industry over the last several years. Nonetheless, subsidies remain an important part of Ukraine's economy, particularly in the coal and agriculture sectors. These subsidies, however, appear not to be specifically designed to provide direct or indirect support for exports, but rather to maintain full employment and production during the transition to a market-based economy. The government does not target export subsidies specifically to small business. (Ukrainian exporters, however, now enjoy a number of tax benefits, such as the VAT applied at a zero rate.) Ukraine's subsidy policy may change in the context of its negotiations to join the World Trade Organization (WTO). The country's sixth WTO Working Party meeting was held in the summer of 1998. Ukraine has tabled WTO market access offers for both goods and services, though its accession process is proceeding slowly.

8. Protection of U.S. Intellectual Property

Ukraine is a member of the World Intellectual Property Organization, the Paris and Madrid Conventions, and a party to the Patent Cooperation Treaty, the Universal Copyright Convention, and the Berne Convention. It has also established a comprehensive legislative system for the protection of Intellectual Property Rights (IPR). Enforcement of IPR legislation is weak, however. Estimates are that over 90 percent of computer software in Ukraine is pirated, and piracy of video and audio recordings is widespread. On May 1, 1998, Ukraine was placed on the USTR's "Special 301" Watch List because of substantial losses to U.S. industry caused by copyright piracy. There is no data available concerning infringement of trademarks in Ukraine.

9. Worker Rights

a. The Right of Association: The constitution provides for the right to join trade unions to defend "professional, social and economic interests." Under the constitution, all trade unions have equal status, and no government permission is required to establish a trade union. The 1992 Law on Citizens' Organizations (which includes trade unions) stipulates noninterference by

public authorities in the activities of these organizations, which have the right to establish and join federations on a voluntary basis. In principle, all workers and civil servants (including members of the armed forces) are free to form unions. In practice, the government discourages certain categories of workers, for example, nuclear power plant employees, from doing so. The successor to the Soviet trade unions, known as the Federation of Trade Unions (FPU), has begun to work independently of the government and has been vocal in advocating workers' right to strike. Independent unions now provide an alternative to the official unions in many sectors of the economy. The constitution provides for the right to strike "to defend one's economic and social interests." The constitution also states that strikes must not jeopardize national security, public health, or the rights and liberties of others.

b. The Right to Organize and Bargain Collectively: The Law on Enterprises states that joint worker-management commissions should resolve issues concerning wages, working conditions, and the rights and duties of management at the enterprise level. Overlapping spheres of responsibility frequently impede the collective bargaining process. The government, in agreement with trade unions, establishes wages in each industrial sector and invites all unions to participate in the negotiations. The Law on Labor Disputes Resolution that came into force in March 1998 provides for establishment of an arbitration service and a National Mediation and Reconciliation Service to mediate in labor disputes. These services, however, have not yet been established. The manner in which the collective bargaining law is applied prejudices the bargaining process against the independent unions and favors the official unions. The collective bargaining law prohibits antiunion discrimination, but there have been cases in which such disputes have not been settled in a fair and equitable manner.

c. Prohibition of Forced or Compulsory Labor: The constitution prohibits compulsory labor, and it is not known to occur. The government does not specifically prohibit forced and bonded labor by children, although, the constitution and the Labor Code prohibit forced labor generally, and such practices are not known to occur. Human rights groups described as compulsory labor the common use of army conscripts and youths in the alternative service for refurbishing and building private houses for army and government officials. Student groups have protested against a Presidential Decree obliging college and university graduates, whose studies have been paid for by the government, to work in the public sector at government-designated jobs for three years or to repay fully the cost of their education.

d. Minimum Age for Employment of Children: The government does not specifically prohibit forced and bonded labor by children. The minimum employment age is 17 years. In certain non-hazardous industries, however, enterprises may negotiate with the government to hire employees between 14 and 17 years of age, with the consent of one parent.

e. Acceptable Conditions of Work: The Labor Code provides for a maximum 40-hour workweek, a 24-hour day of rest per week, and at least 24 days of paid vacation per year. The

law contains occupational safety and health standards, but these are frequently ignored in practice. In 1997, 1,646 people were killed and 51,888 injured in accidents at work, with an equally high figure projected for 1998. In theory, workers have a legal right to remove themselves from dangerous work situations without jeopardizing continued employment. Independent trade unionists have reported, however, that asserting this right would result in retaliation or perhaps dismissal by management.

f. Rights in Sectors with U.S. Investment: Enterprises with U.S. investment frequently offer higher salaries and are more observant of regulations than their domestic counterparts. Otherwise, conditions do not differ significantly in sectors with U.S. investment from those in the economy in general.

**Extent of U.S. Investment in Selected Industries -- U.S. Direct Investment Position Abroad
on an Historical Cost Basis -- 1997**

(Millions of U.S. Dollars)

Category	Amount
Petroleum	0
Total Manufacturing	-4
Food & Kindred Products	0
Chemicals & Allied Products	0
Primary & Fabricated Metals	0
Industrial Machinery and Equipment	0
Electric & Electronic Equipment	0
Transportation Equipment	0
Other Manufacturing	-4
Wholesale Trade	(1)
Banking	0
Finance/Insurance/Real Estate	0
Services	0
Other Industries	(1)
TOTAL ALL INDUSTRIES	(2)

(1) Suppressed to avoid disclosing data of individual companies.

(2) Less than \$500,000 (+/-).

Source: U.S. Department of Commerce, Bureau of Economic Analysis.